# Introduction

## John Simon

The global financial crisis demonstrated how interconnected the global economy has become. A problem in one part of the global economy was rapidly spread by the financial system to every part. It made it clear that financial stability was not just the concern of bank regulators, but of all policymakers. In Australia, the interplay between macroeconomic and financial stability objectives has made the setting of monetary policy especially challenging. In particular, there are concerns that the low interest rates required to support macroeconomic objectives might be contributing to a build-up of financial stability risks, particularly those related to household balance sheets. This concern is not unique to Australia. Similar policy debates have occurred in countries around the world.

To learn from these policy debates and the large body of associated research that has developed since the financial crisis, the Reserve Bank held a conference in March 2017. The conference brought together a range of experts to discuss the relationship between financial and macroeconomic stability, and the approach to policymaking that a world of low interest rates requires. The conference was divided into three main sessions. The first session of the conference was devoted to establishing some facts about monetary policy, financial stability and their interactions. The next session looked at how institutional arrangements adapted and responded to the post-financial crisis world of low growth and heightened financial stability concerns. The final session of the conference built upon the first two sessions by considering how a monetary policy authority should incorporate financial stability concerns into its policy actions. The conference concluded with a panel discussion synthesising the themes of the conference. The papers, the discussants' comments and a summary of the discussions that followed these presentations are included in this volume.

The first session included papers by Reserve Bank economists Adam Cagliarini and Fiona Price, and BIS economists Claudio Borio and Boris Hofmann. Dr Cagliarini and Ms Price look at the relationship between financial and macroeconomic, or business, cycles. They reflect on an existing body of work that has generally argued that the business and financial cycles are distinct features of the economy, and that financial cycles are longer than business cycles. In contrast to the earlier literature, however, their paper finds that there is little statistical evidence that financial and business cycles operate at different frequencies. Despite this, the two cycles are not always synchronised. The authors consider how monetary policy should respond when the cycles are out of sync. They conclude that, while monetary policy has an effect on the financial cycle, there are limitations on its ability to manage the business and financial cycles at the same time. On the other hand, they observe that macroprudential policy has the flexibility to help manage the financial cycle. As such, they advocate a coordinated approach to achieving economic and financial objectives with trade-offs managed across institutions rather than within institutions.

Dr Borio and Dr Hofmann look at whether monetary policy is less effective when interest rates are persistently low. Despite nominal interest rates being at or below zero in many advanced economies, economic growth since the financial crisis has disappointed. This has led some to question the effectiveness of monetary policy when interest rates are at low levels. The authors investigate this correlation by providing a detailed review of the theoretical and empirical literatures. They highlight two possible reasons for the observed outcomes: headwinds, such as debt overhang, that coincide with periods of low interest rates; or decreased effectiveness of monetary policy when interest rates are low. With headwinds, monetary policy is as effective as always, but drags on growth from other areas of the economy mean that the observed effect of low interest rates can be small. Conversely, with decreased effectiveness, monetary policy itself is much less effective. The authors discuss a number of reasons this might occur, most of which are linked to the presence of distortions as nominal interest rates approach zero. For example, investors may be seeking particular nominal – as opposed to real – rates of return, which could lead them to lower their consumption and raise their saving as nominal rates reach low levels. This would lessen the effectiveness of interest rate cuts. The authors acknowledge that there are significant issues separating headwinds from declining effectiveness and that more work is needed but, notwithstanding these difficulties, they conclude that there is evidence of both strong headwinds and a decline in policy effectiveness.

The second session, focused on how financial stability institutions have developed since the financial crisis, included papers by Rochelle Edge and Nellie Liang, and Luci Ellis and Charles Littrell. The paper by Dr Edge and Dr Liang examines the structure of financial stability committees around the world, with a particular focus on whether the choice of structure is related to certain country-specific observables. They highlight the particularly prominent role of central banks on these committees, but also note that finance ministries frequently chair these committees, particularly in advanced economies. Overall, they find that the majority of countries have financial stability committees in place to measure and monitor systemic risks, and that most these have been set up since the crisis. However, they also find that relatively few of these bodies have independent powers, and that they tend to focus on promoting information sharing and coordination. They express a concern that this lack of powers could limit the ability of these bodies to improve financial stability outcomes.

The second paper is a case study of Australia, focused on how interactions between the central bank and the prudential regulator in charge of financial stability have worked in practice. The authors emphasise the cooperative, system-wide perspectives adopted by both APRA and the RBA in their approach to financial stability. They argue that this approach stemmed from the history of the two institutions as much as from the formal institutional structure. For while APRA's legislation enshrined a formal mandate for financial stability, the failure of HIH early in APRA's life had significant effects on its culture and approach to regulation. The authors further emphasise how the productive relationship between the two agencies was aided by personal connections between the institutions. At first this reflected the fact that APRA was initially staffed by many RBA employees who were transferred to the institution when APRA was set up, but later it reflected established cultural expectations and performance goals for key staff. Overall, the paper makes a strong case for the benefits that can flow from having two regulators working together cooperatively, rather than competitively.

The final session included a paper from the IMF reviewing the arguments for and against setting interest rates higher than is indicated by a traditional inflation-targeting framework, that is 'leaning against the wind', and a panel discussion to synthesise the views presented at the conference. The paper from the IMF, presented by Giovanni Dell'Ariccia, considers how a central bank should balance macroeconomic and financial stability concerns when setting interest rates. Leaning against the wind leads to lower inflation and higher unemployment than otherwise. These costs are compared to the harder-to-measure and longer-term benefits that arise from mitigating an increase in financial risks. They conclude that, based on current knowledge, the case for leaning against the wind is limited, as in most circumstances costs outweigh benefits. Nevertheless, they do note that our understanding of the interaction between monetary policy and financial stability is still evolving and that future research in this area is a key priority.

The panel discussion first focused on a number of themes that had emerged from the papers and discussions over course of the conference. A particularly common theme was the importance of institutions. It was noted, however, that while regulators around the world are implementing many changes to both institutional arrangements and macroprudential policy, there is no clear best practice. While institutions focused on financial stability have grown and evolved, they have done so in idiosyncratic ways rather than being guided by well-tested principles. Another consistent theme was how much remains unknown. In this respect a number of areas for future research were nominated. These areas reflected how interconnected economies and financial systems had become. For example, it was suggested that understanding networks is crucial to understanding how shocks to individual households or institutions can propagate. Modelling the linkages between financial systems and the macroeconomy was also nominated as a particularly important area for more research.

Reflecting the need for more research, panellists also commented on the difficulty of assessing the effectiveness of macroprudential policies as well as the difficulties associated with implementing them. They highlighted the political constraints on macroprudential policy that could limit their effectiveness. In particular, it was observed that macroprudential policy invariably involves restricting access to credit for a particular group of people – and this group has an incentive to either circumvent the restrictions or to lobby for them to be relaxed. The discussion concluded by considering the role of monetary policy in financial stability and of macroprudential policy in financial stability.

## The Sense of the Room

Over the course of the two days many views were expressed and it is difficult to do them justice in this short introduction. This is particularly so because the topic is one where much remains to be understood and a number of views are held tentatively until better evidence comes to hand. Reflecting this, there was general agreement that more work is needed to better understand both the effects of macroprudential measures and their interactions with monetary policy. In particular, it was felt that more work on macroprudential institutions would be particularly valuable. While monetary policy frameworks have evolved over the course of decades and are relatively mature, macroprudential frameworks are still in their infancy. Across jurisdictions, a range of approaches had developed and this diversity would eventually provide a wide range of experiences to learn from. As such, it was felt that frameworks would undoubtedly evolve and that policy institutions should be ready to modify their frameworks and approaches as evidence on best practices emerged.

Reflecting the immaturity of policy frameworks and knowledge, there was disagreement over whether monetary policy should be the first line of defence against financial stability risks. Many participants felt that the available evidence was sufficient to conclude, as the IMF staff had in the paper presented by Dr Dell'Ariccia, that monetary policy should be set according to macroeconomic considerations rather than leaning against the wind. These participants generally believed that macroprudential policy should form the first line of defence against financial imbalances while keeping open the possibility that in some circumstances a monetary policy response might be warranted.

Notwithstanding this disagreement, there was consensus about the importance of having all arms of policy working together. In discussions about institutional arrangements it was observed that outcomes appeared to be better when regulators took a cooperative and macroeconomic perspective on regulation, rather than an adversarial or narrower perspective.


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